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September 11, 2006

**AGENDA ITEM 7a**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Domestic Equity Manager Annual Review
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Renew the contracts for CalPERS' four active managers and nine enhanced indexing managers listed below. Wilshire's opinion letter is shown in Attachment 1. Wilshire's disclosure letter is shown in Attachment 2.

**Active Managers**

AllianceBernstein L.P.  
The Boston Company  
Geewax, Terker & Company  
Pzena Investment Management

**Enhanced Indexing Managers**

Atlantic Asset Management  
Barclay's Global Investors  
Franklin Portfolio Associates  
Goldman Sachs Asset Management  
INTECH  
Quantitative Management Associates  
Smith Breeden  
T. Rowe Price  
Western Asset Management Company

**IV. ANALYSIS:**

**Executive Summary**

The performance of the external domestic equity manager program for the fiscal year ending June 30, 2006 was disappointing but improved over the prior fiscal year. Because of a number of actions taken during the course of the fiscal year, it is expected that the improvement in performance will continue. Total program performance was 0.54% below benchmark as shown in Table 4 of the report. Total active manager performance was 2.01% below benchmark while total enhanced indexing manager performance was 0.20% above the benchmark.

A number of actions have been taken to improve performance. First, four underperforming active managers resigned their accounts during the fiscal year. Second, two additional enhanced indexing managers were added to seven such managers funded in fiscal year 04/05. Within the enhanced indexing group, more money was allocated to the stock-based managers as staff anticipated that a rising interest rate environment would prove challenging to the managers using a synthetic strategy. This assessment proved to be correct.

In addition, the Investment Committee gave staff approval to conduct a domestic growth manager search on December 12, 2005. Staff completed the search and the Investment Committee approved the pool of six managers on August 14, 2006. On February 14, 2006 the Investment Committee gave staff approval to conduct a search for long/short equity managers that invest their portfolios up to 130% long and 30% short. Staff is conducting the search and expects to have a pool of managers for the Investment Committee's review by the December 2006 meeting.

Individual manager performance reports begin on page 10 of this agenda item.

### **Background**

CalPERS' external active domestic equity program consists of four active managers and nine enhanced indexing managers. The active managers were funded over the period from May 31, 1998 through October 2002, while the enhanced indexing managers were funded from September 2004 through April 2006.

On July 31, 1998, CalPERS implemented the internally managed Dynamic Completion Fund (DCF) which complements the portfolios of the active and enhanced domestic equity managers. The objective of the DCF is to mitigate style and capitalization biases within the external domestic equity portfolios relative to the CalPERS Custom Wilshire 2500 benchmark.

All managers in this program have one year renewable contracts contingent upon the Investment Committee's annual approval as presented in this agenda item. Each contract contains a provision allowing for termination upon 30 days notice.

### **Assets Under Management**

As of June 30, 2006, total assets under management for CalPERS' active domestic equity program (including the DCF) were approximately \$14.9 billion. Table 1 on the next page shows the assets managed by each manager as of June 30, 2006.

**Table 1**

<b>Manager</b>	<b>Portfolio Value (in millions)</b>	<b>Percent of Portfolio</b>
<b>Active Managers</b>		
AllianceBernstein L.P.	\$690	4.6%
The Boston Company	\$663	4.5%
Geewax, Terker & Company	\$513	3.4%
Pzena Investment Mgmt.	\$675	4.5%
<b>Total Active</b>	<b>\$2,541</b>	<b>17.0%</b>
<b>Enhanced Managers</b>		
Atlantic Asset Mgt	\$342	2.3%
Barclay's Global Investors	\$1,086	7.3%
Franklin Portfolio Associates	\$941	6.3%
Goldman Sachs Asset Mgmt.	\$464	3.1%
INTECH	\$1,259	8.4%
Quantitative Mgt Associates	\$932	6.3%
Smith Breeden	\$580	3.9%
T. Rowe Price	\$585	3.9%
Western Asset Mgmt. Co.	\$586	3.9%
<b>Total Enhanced</b>	<b>\$6,774</b>	<b>45.4%</b>
Dynamic Completion Fund	\$5,598	37.6%
<b>Total</b>	<b>\$14,913</b>	<b>100.0%</b>

Source: State Street Bank.

### **Market Environment**

U.S. stocks posted positive returns for the trailing 12 months ending June 30, 2006. During this period oil prices were volatile, spiking to over \$69/barrel on August 30, 2005 after hurricane Katrina and peaking at over \$75/barrel on April 21, 2006 due to tensions in the Middle East. While higher oil prices could have had a negative effect on our economy, consumer confidence continued trending up as the economy supported more jobs and strong GDP growth continued.

During the past 12 months the Federal Reserve has raised the Federal Funds interest rate from 3.25% to 5.25% at the end of June 2006. Historically, a period of rising interest rates does not preclude rising equity valuations as long as economic growth is sustained and earnings continue to advance. However, current price/earnings ratio valuation spreads, the range between the highest priced stocks and the lowest priced stocks relative to earnings, are very narrow and significantly below the long-term average, representing a challenging investment environment.

For the 12 month period ending June 30, 2006, the Custom Wilshire 2500 had the highest performance of the indices, which reflects a spectrum of possible investment opportunities in the US market, listed in Table 2.

**Table 2**

<b>Index</b>	<b>Return for the Year Ending June 30, 2006</b>
Custom Wilshire 2500	9.50%
S&P 500	8.63%
NASDAQ	5.60%

Table 3 shows the disparity of returns between style and size indices during the period. For the 12 month period ending June 30, 2006, the Custom Wilshire Small Cap Value Index performed the strongest, finishing up 15.72%. Growth (both large and small cap) indices posted positive returns over the same period, but both underperformed the value indices.

**Table 3**

<b>Index</b>	<b>July 2005 - June 2006</b>	
	<b>Growth</b>	<b>Value</b>
CalPERS Wilshire Large	4.97%	12.46%
CalPERS Wilshire Small	15.03%	15.72%
Russell 1000 (Large)	6.12%	12.10%
Russell 2000 (Small)	14.58%	14.61%

### **Program Performance Objective**

The portfolio of active and enhanced indexing managers is expected to exceed its composite benchmark over a full market cycle of three to five years. The objective of the DCF is to mitigate style and capitalization biases within the external domestic equity portfolios relative to the CalPERS Custom Wilshire 2500 benchmark.

### **Program Performance**

Total program performance was 0.54% below benchmark as shown in Table 4 below. Total active manager performance was 2.01% below benchmark while total enhanced indexing manager performance was 0.20% above the benchmark. From inception through June 30, 2006, the program has outperformed the composite benchmark by 0.25%. The since inception return with the DCF added increases to 0.41%. Please note that program returns include partial year performance of four managers that underperformed their respective benchmarks and resigned during the past fiscal year.

All manager and composite performance numbers shown in this report are CFA Institute compliant and net of fees.

**Table 4**

	Fiscal Year 01/02	Fiscal Year 02/03	Fiscal Year 03/04	Fiscal Year 04/05	Fiscal Year 05/06	Calendar YTD 2006	Annualized Since Inception*
External Active Managers	-18.34%	1.04%	22.39%	7.15%	9.07%	2.75%	4.97%
Composite Benchmark	-16.56%	1.28%	22.88%	9.75%	11.08%	4.75%	5.23%
<b>Active Return</b>	<b>-1.78%</b>	<b>-0.24%</b>	<b>-0.49%</b>	<b>-2.60%</b>	<b>-2.01%</b>	<b>-2.00%</b>	<b>-0.26%</b>
Enhanced Indexing Mgrs	N/A	N/A	N/A	N/A	9.35%	3.25%	10.87%
Composite Benchmark	N/A	N/A	N/A	N/A	9.15%	3.05%	10.29%
<b>Active Return</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>0.20%</b>	<b>0.20%</b>	<b>0.58%</b>
Active & E I Managers	-18.34%	1.04%	22.39%	6.81%	9.25%	3.10%	11.63%
Composite Benchmark	-16.56%	1.28%	22.88%	8.94%	9.79%	3.67%	11.38%
<b>Active Return</b>	<b>-1.78%</b>	<b>-0.24%</b>	<b>-0.49%</b>	<b>-2.13%</b>	<b>-0.54%</b>	<b>-0.57%</b>	<b>0.25%</b>
Active, Enhanced + DCF	-17.77%	1.14%	19.85%	6.27%	8.76%	2.67%	4.12%
Custom Wilshire 2500	-17.37%	1.13%	20.58%	7.55%	9.50%	3.15%	3.71%
<b>Active Return</b>	<b>0.40%</b>	<b>0.01%</b>	<b>-0.73%</b>	<b>-1.28%</b>	<b>-0.74%</b>	<b>-0.48%</b>	<b>0.41%</b>

\*Program inception Dates: Active, 5/31/98, DCF, 7/31/98, Enhanced, 9/30/04.

Source: State Street Bank. Returns are net of fees and CFA compliant.

## **Performance by Manager**

Table 5 illustrates each manager's performance relative to its respective benchmark since the initial funding date. Commentary on each manager is contained in the individual manager reports beginning on page 10 of this agenda item.

**Table 5**

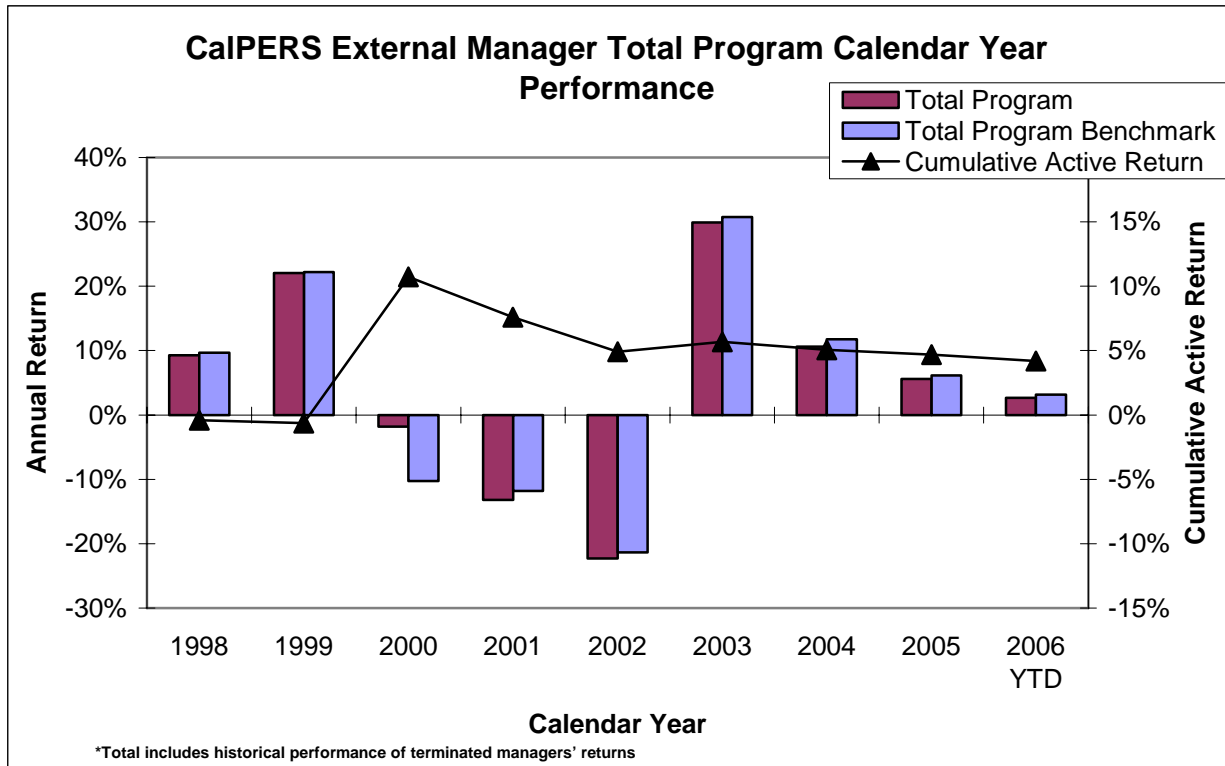
External Manager	Fiscal Year 01/02 Active Return	Fiscal Year 02/03 Active Return	Fiscal Year 03/04 Active Return	Fiscal Year 04/05 Active Return	Fiscal Year 05/06 Active Return	Annualized Since Inception Active Return through June 30, 2006	Inception Date
<b>Active Managers</b>							
Alliance Bernstein	5.45%	-1.24%	-1.69%	-0.57%	-1.20%	2.85%	Sept 2000
Boston Company	-5.31%	3.99%	2.97%	0.04%	3.48%	0.92%	June 1998
Geewax, Terker &	4.16%	-4.62%	-1.04%	3.31%	2.04%	0.29%	June 1998
Pzena Investment	7.96	5.89%	4.31%	-2.10%	-6.80%	4.38%	Sept 2000
<b>Enhanced Mgrs *</b>							
Atlantic Asset Mgt	N/A	N/A	N/A	-1.00%	-0.96%	-1.19%	Nov 2004
Barclays Global Inv	N/A	N/A	N/A	N/A	3.08%	3.08%	Oct 2005
Franklin Portfolio A	N/A	N/A	N/A	0.00%	1.08%	0.62%	Oct 2004
Goldman Sachs SC	N/A	N/A	N/A	1.15%	-2.77%	-1.04%	Feb 2005
INTECH	N/A	N/A	N/A	2.87%	-0.85%	1.14%	Oct 2004
Quantitative Mgt A	N/A	N/A	N/A	1.84%	0.13%	1.14%	Oct 2004
Smith Breeden	N/A	N/A	N/A	-0.21%	0.08%	-0.07%	Nov 2004
T. Rowe Price	N/A	N/A	N/A	N/A	-0.20%	-0.20%	Apr 2006
WAMCO	N/A	N/A	N/A	0.30%	0.08%	0.08%	Oct 2004

\* First fiscal year shown is a partial year based on inception date.

Source: State Street Bank. Returns are net of fees and CFA compliant.

Figure 1 illustrates the annual and cumulative performance of the Total Program, which includes the DCF, relative to its CalPERS' Custom Wilshire 2500 benchmark.

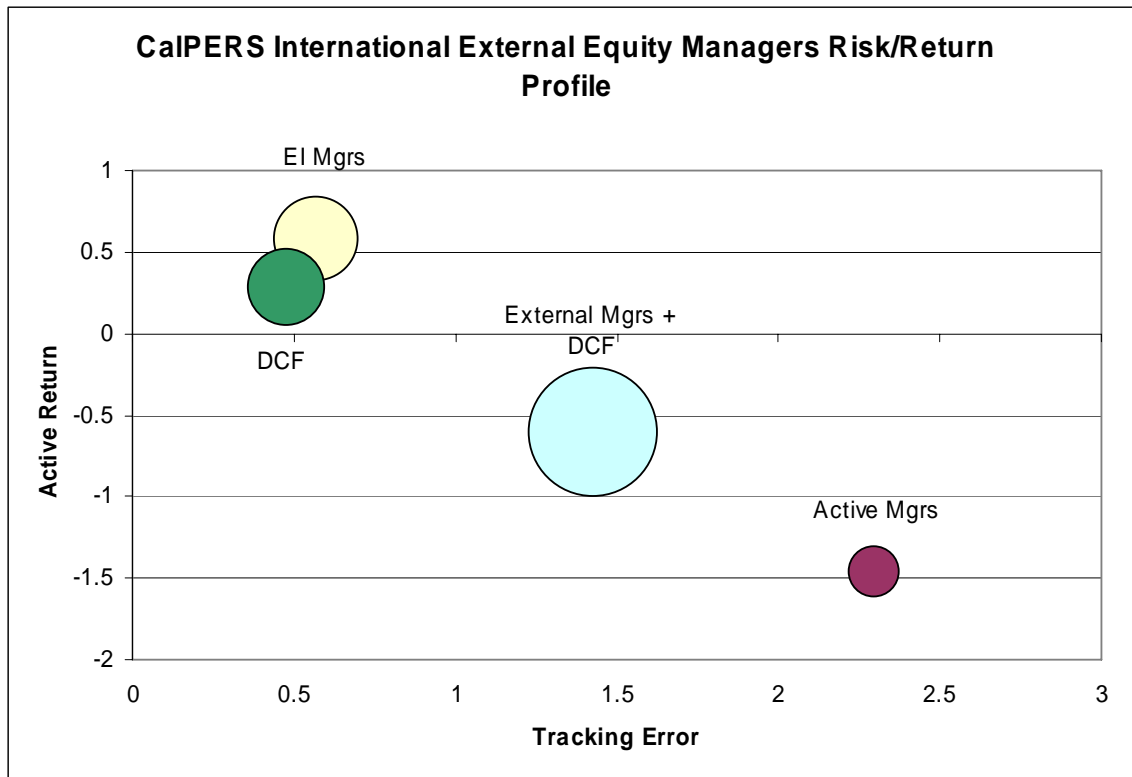
**Figure 1**



Source: State Street Bank. Returns are net of fees and CFA compliant.

Figure 2 shows the risk and performance of the domestic equity program and its three components.

**Figure 2**



(Period reflected for managers' risk/return profile is June 2001 to June 2006 for all managers except the enhanced indexing managers, which is October 2004 to June 2006)

### Managers' Style

Figures 3 and 4 show how the composites and portfolios plot on a manager style chart. The style (value to growth) is measured on the horizontal axis and size (large capitalization to small capitalization) is measured on the vertical axis. Each quadrant represents a style box.

Figure 3 illustrates how the composites for active, enhanced indexing and total external equity along with the Dynamic Completion Fund compare to the CalPERS Custom Wilshire 2500 benchmark.

**Figure 3**

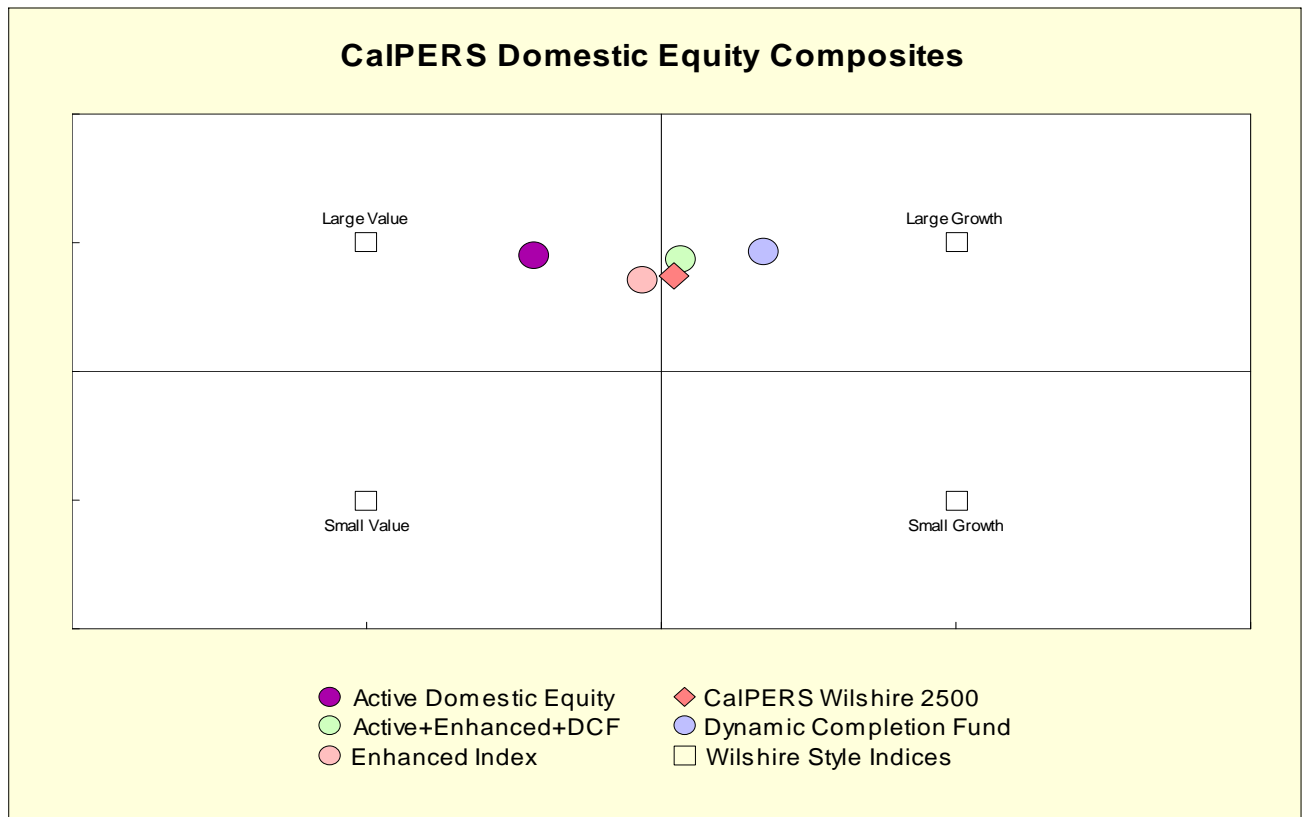
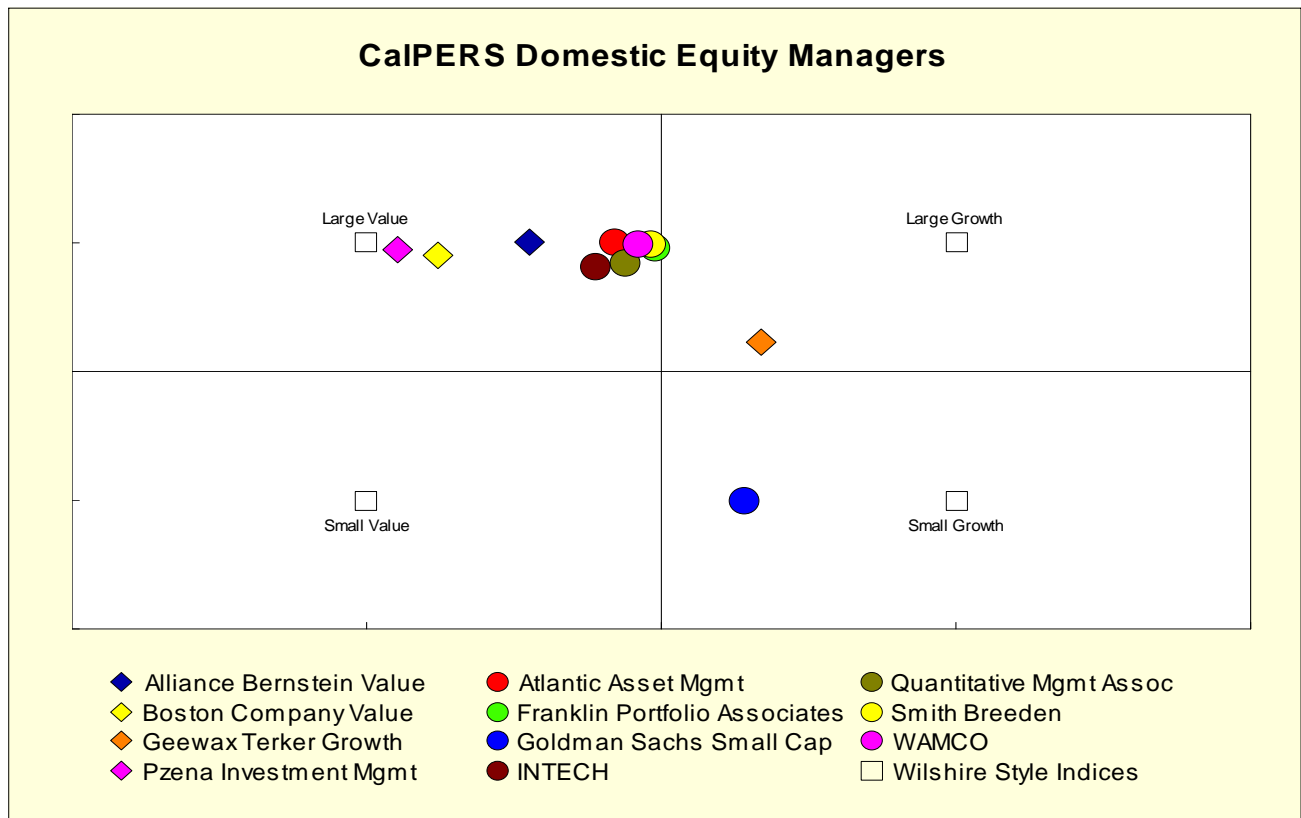




Figure 4 illustrates how all of the enhanced indexing managers reside in the large cap core quadrant with the exception of Goldman Sachs which invests in small cap stocks. Both Pzena Investment Management and The Boston Company reside in the large value quadrant. Alliance Bernstein is large core/value while Geewax primarily invests in more core/growth companies that are smaller cap. Please note that two recently funded enhanced indexing managers are not included here due to insufficient data points to complete this analysis.

**Figure 4**



The following pages provide information on each manager in the active domestic equity program.

## Individual Managers Performance and Evaluation

### **AllianceBernstein L.P. – Active Manager**

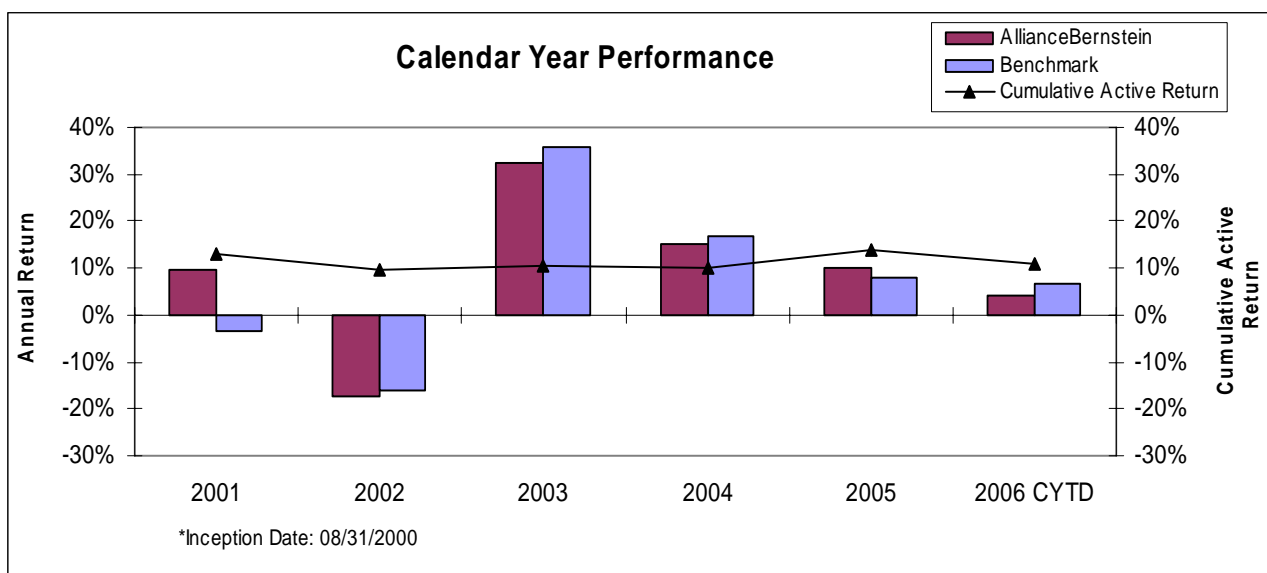
AllianceBernstein L.P., funded on August 31, 2000, takes a bottom-up approach to security selection. The firm compares the present value of each company's future cash flow, as forecasted by their analysts, to the current price of the stock. Companies are ranked from the highest expected return to the lowest. Once the expected return is calculated for each stock, an adjustment is made for timing risk and concentration risk. Securities from the top two quintiles of their valuation universe are selected with an optimal trade-off of risk and return.

While recent relative performance has been negative, since inception, this manager has outperformed their benchmark. In part, their strategy has been negatively affected by the narrow range in valuations between the most and least expensive stocks, which limits opportunities. In addition, stock selection in financials, industrials, and technology sectors particularly hurt this last year's performance. Assets under management as of June 30, 2006, were \$690.1 million.

	Fiscal Year 01/02	Fiscal Year 02/03	Fiscal Year 03/04	Fiscal Year 04/05	Fiscal Year 05/06	Inception* Annualized
AllianceBernstein.	-2.59%	-0.70%	23.19%	12.84%	11.75%	10.59%
Benchmark	-8.04%	0.54%	24.88%	13.41%	12.95%	7.74%
Active Return	5.45	-1.24	-1.69%	-0.57%	-1.20%	2.85%

\*Inception Date: 08/31/2000. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows AllianceBernstein's performance versus its benchmark. The axis on the left measures the manager's annual performance against its benchmark. The right axis measures AllianceBernstein's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## The Boston Company – Active Manager

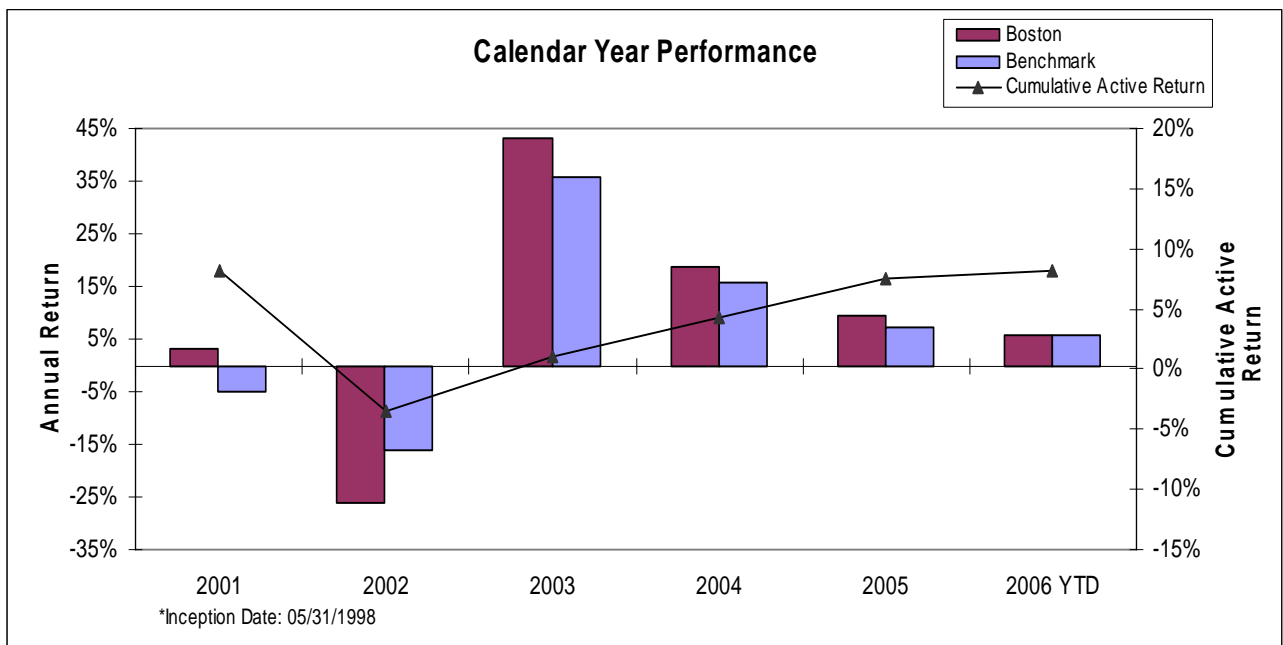
The Boston Company (TBC) was funded on May 31, 1998, as an active domestic equity value manager. TBC's Dynamic Value Equity Management product utilizes a bottom-up, value-oriented investment approach rooted in detailed fundamental analysis. The three-step analysis includes: 1) quantitative and fundamental business analysis of the individual companies, 2) valuation of the market as a whole, and 3) valuation of broadly defined segments of the market. Once the analysis is complete, the portfolio manager over-weights the market segments with the best value characteristics and chooses companies within each market segment with the best fundamentals.

For the fiscal year ending June 30, 2006, the portfolio outperformed its custom Wilshire benchmark by 3.48%. Solid stock selection, particularly in the healthcare and consumer discretionary sectors, drove the portfolio's strong relative performance. Assets under management as of June 30, 2006 were \$663.4 million.

	Fiscal Year 01/02	Fiscal Year 02/03	Fiscal Year 03/04	Fiscal Year 04/05	Fiscal Year 05/06	Inception* Annualized
The Boston Co.	-14.37%	5.08%	27.81%	11.61%	15.48%	8.11%
Benchmark	-9.06%	1.09%	24.84%	11.57%	12.00%	7.19%
Active Return	-5.31%	3.99%	2.97%	0.04%	3.48%	0.92%

\*Inception Date: 05/31/1998. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows TBC's performance versus its benchmark. The axis on the left measures the manager's annual performance against its benchmark. The right axis measures TBC's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Geewax, Terker & Co. – Active Manager

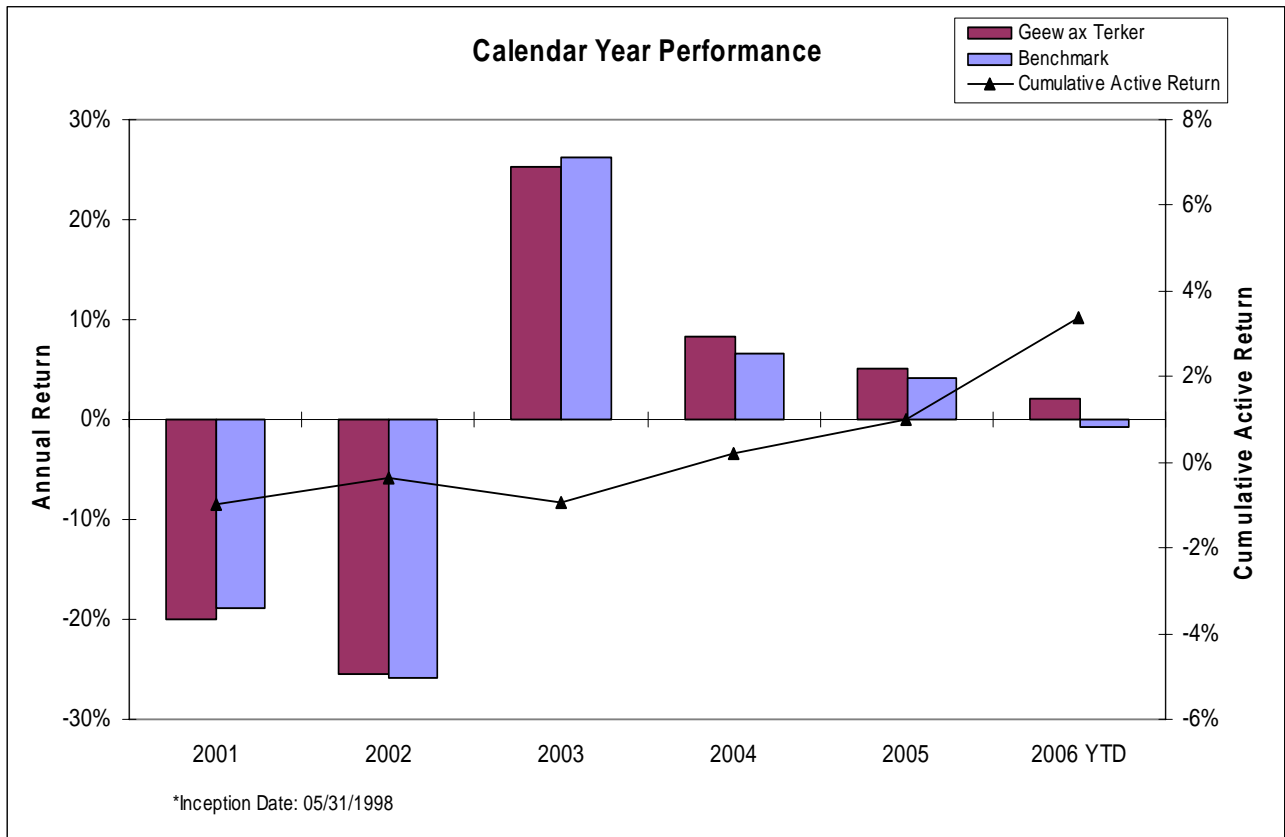
Geewax Terker was funded on May 31, 1998 as an active domestic equity growth manager. The firm utilizes a fundamentally driven, bottom-up growth investment style. Geewax seeks to capitalize on the overly optimistic expectations of other investors in the growth equity market by avoiding stocks likely to underperform based on a variety of valuation factors. A quantitative screening process is utilized that eliminates companies that have poor financial quality, missed earnings projections, or significant insider selling.

Geewax's strong relative performance continued for the second consecutive fiscal year. Driving the manager's strong performance was the decision to take large overweight positions in the industrial and energy sectors. Assets under management as of June 30, 2006 were \$513.3 million.

	Fiscal Year 01/02	Fiscal Year 02/03	Fiscal Year 03/04	Fiscal Year 04/05	Fiscal Year 05/06	Inception* Annualized
Geewax Terker	-21.23%	-2.38%	15.61%	4.83%	7.61%	0.34%
Benchmark	-25.39%	2.24%	16.65%	1.52%	5.57%	0.05%
Active Return	4.16%	-4.62%	-1.04%	3.31%	2.04%	0.29%

\*Inception Date: 05/31/1998. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows Geewax's performance versus its benchmark. The axis on the left measures the manager's annual performance against its benchmark. The right axis measures Geewax's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Pzena Investment Management – Active Manager

Pzena was funded on August 31, 2000 as an all-cap, deep value manager whose portfolio is concentrated in 30 to 40 stocks. This manager seeks stocks whose prices are low relative to their long-term normal earnings power. The manager then evaluates each company's position within its industry and incorporates its judgment as to the company's ability to successfully implement its strategic business plan.

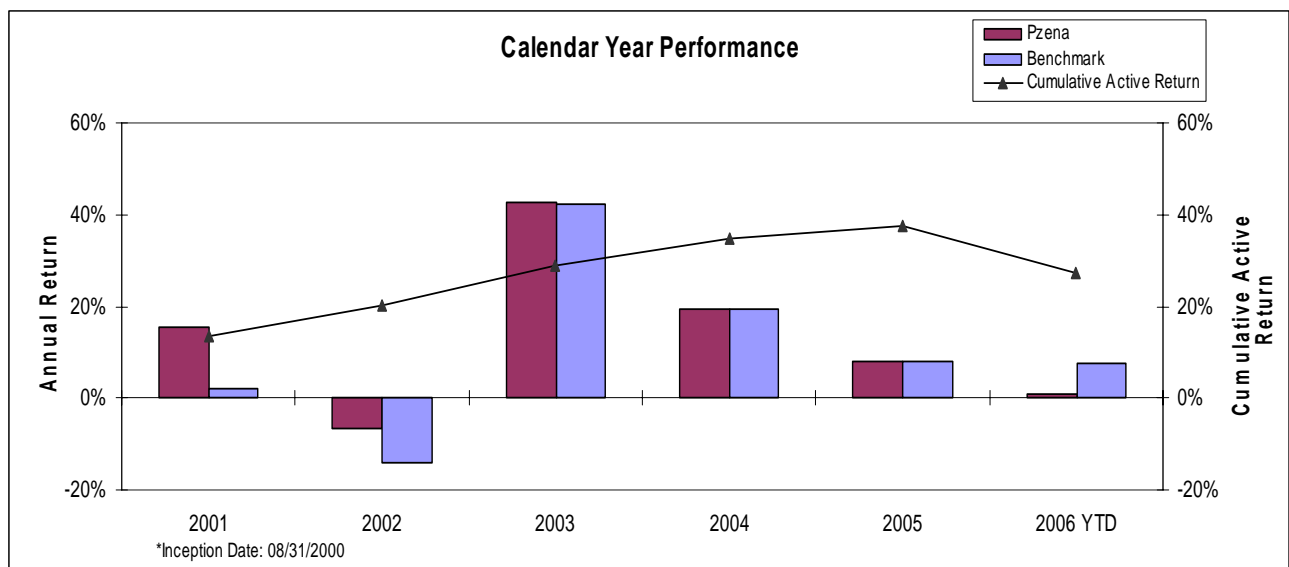
Pzena experienced its second consecutive fiscal year of underperformance. The manager's style is to invest only in companies that experienced some significant event that places it out of favor with investors. That style hurt performance as investors concentrated mostly on energy and commodity-related companies.

Also contributing negatively to the manager's underperformance was its large weight in large cap stocks relative to its Wilshire custom benchmark, which is a blend of fifty-five percent large cap value stocks and 45% percent small cap value stocks. Small cap stocks had very strong performance in the month of January and the manager underperformed by 3.41% in that month alone. Assets under management as of June 30, 2006 were \$675.1 million.

	Fiscal Year 01/02	Fiscal Year 02/03	Fiscal Year 03/04	Fiscal Year 04/05	Fiscal Year 05/06	Inception* Annualized
Pzena	5.77%	7.04%	34.85%	11.57%	7.17%	15.82%
Benchmark	-2.19%	1.15%	30.54%	13.67%	13.97%	11.44%
Active Return	7.96%	5.89%	4.31%	-2.10%	-6.80%	4.38%

\*Inception Date: 08/31/2000. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows Pzena's performance versus its benchmark. The axis on the left measures the manager's annual performance against its benchmark. The right axis measures Pzena's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Atlantic Asset Management – Enhanced Indexing Manager

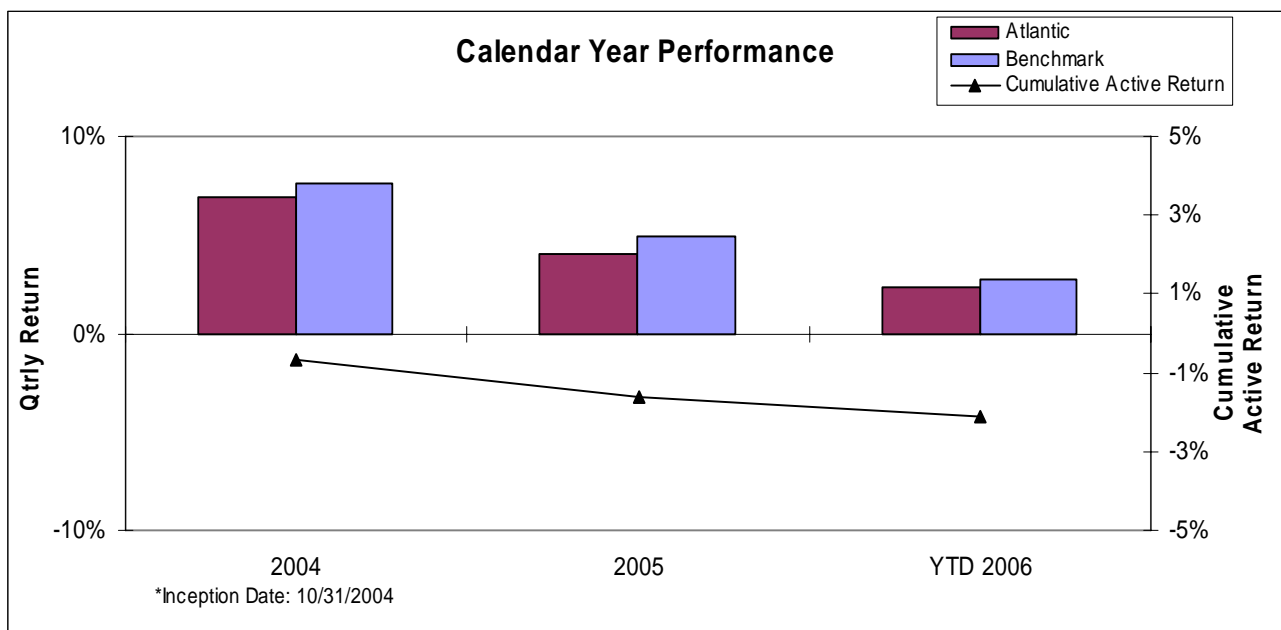
Atlantic's synthetic enhanced indexing strategy was funded on November 1, 2004. Enhanced cash and S&P 500 futures (or swaps) are managed together with the objective to synthetically replicate and exceed the S&P 500 index return. The goal of the enhanced cash portfolio is to obtain higher yields and returns than LIBOR by modestly extending maturities and diversifying the portfolio into various sectors of the bond market. Risk is controlled by managing the average duration of the enhanced cash portfolio to a maximum of two years and diversifying the portfolio by bond market sector and issuer concentration.

The manager underperformed its benchmark by 0.96% for the fiscal year. The U.S. Federal Reserve Board has raised short term interest rates a quarter point for 17 consecutive meetings. With a raise in interest rates, and a flattening out of the yield curve, it is a particularly tough investment environment for a manager whose primary source of excess return is extending out on the yield curve. Assets under management as of June 30, 2006 were \$342.3 million.

	Fiscal Year* 04/05	Fiscal Year 05/06	Inception* Annualized
Atlantic	5.72%	7.67%	8.08%
Benchmark	6.72%	8.63%	9.27%
Active Return	-1.00%	-0.96%	-1.19%

\*Inception Date: 10/31/2004. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows Atlantic's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures Atlantic's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Barclay's Global Investors – Enhanced Indexing Manager

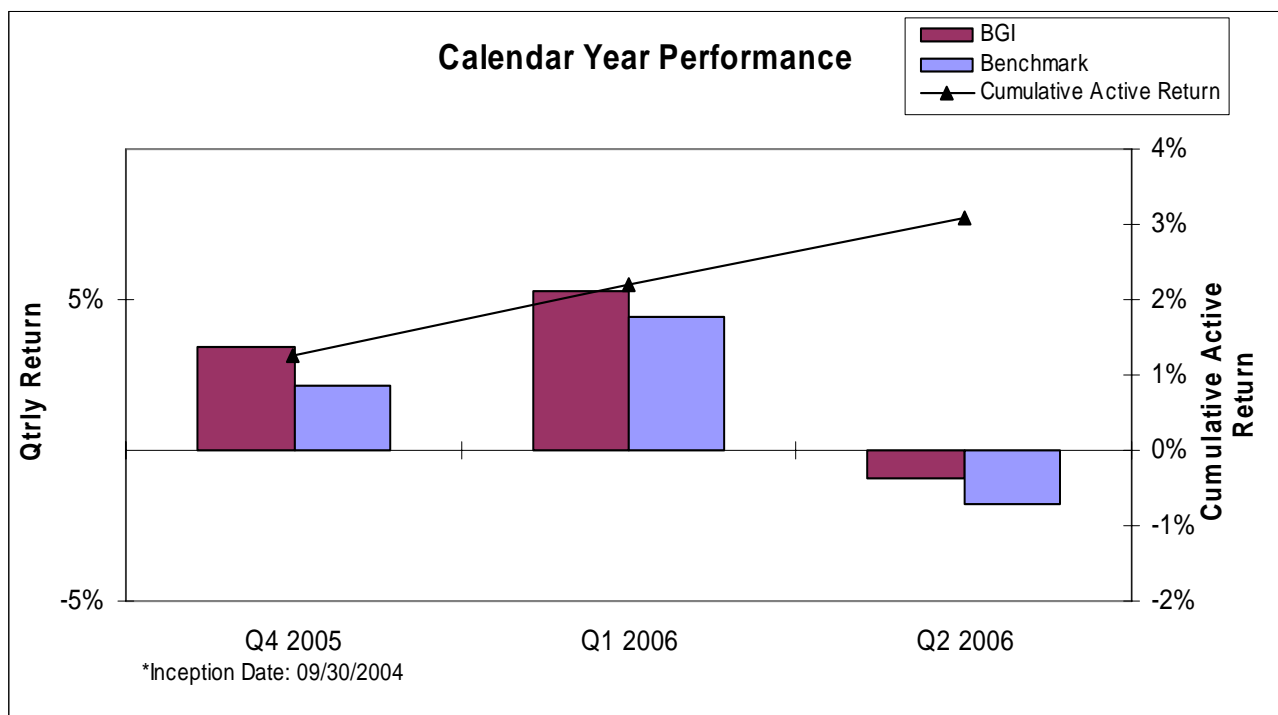
Barclays Global Investors (BGI) was funded on September 30, 2005. BGI's investment philosophy is that superior investment outcomes are most reliably achieved through total performance management - the management of return, risk, and cost. BGI evaluates stocks in terms of their expected "alpha" (excess return) through its CoreAlpha model, which serves as the foundation of its stock selection process. BGI then uses this information in a portfolio optimization process to construct portfolios that are index-like in their risk characteristics but have higher expected returns. The portfolio holdings typically range from 150-350 securities.

In its nine months since the manager's initial funding, the portfolio has outperformed its benchmark by 3.08%. Driving this strong outperformance has been solid stock picking skills across almost all sectors. Assets under management as June 30, 2006 were \$1.09 billion.

	Qtr Ending 12/05	Qtr Ending 03/06	Qtr Ending 06/06	Inception*
BGI	3.40%	5.27%	-0.92%	7.82%
Benchmark	2.13%	4.40%	-1.77%	4.74%
Active Return	1.27%	0.87%	0.85%	3.08%

\*Inception Date: 09/30/2005 Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows BGI's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures BGI's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Franklin Portfolio Associates – Enhanced Indexing Manager

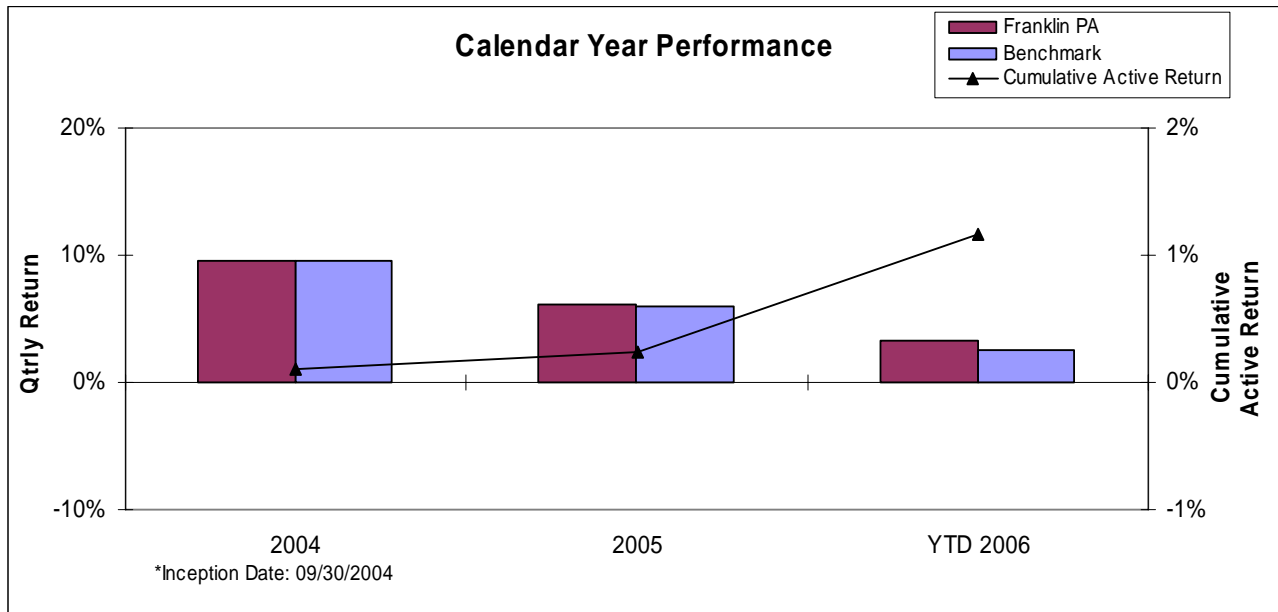
Franklin Portfolio Associates' (FPA), funded on October 1, 2004, has a strategy that emphasizes stock selection while limiting its over or under exposure to sectors and other factors. FPA currently uses over 40 variables to determine a stock's attractiveness. The individual variables are blended together using a proprietary approach to determine a single score of attractiveness. After the valuation process is complete, FPA uses an optimizer to build a portfolio that selects the top-ranked issues while satisfying the risk and diversification requirements.

Overall, the manager has outperformed their benchmark by 62 basis points since inception, which is in line with expectations given its enhanced indexing mandate. Assets under management as of June 30, 2006 were \$940.5 million.

	Fiscal Year* 04/05	Fiscal Year 05/06	Inception* Annualized
Franklin PA	9.39%	9.82%	11.05%
Benchmark	9.39%	8.74%	10.43%
Active Return	0.00%	1.08%	0.62%

\*Inception Date: 09/30/2004. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows FPA's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures FPA's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.



## Goldman Sachs Small Cap – Enhanced Indexing Manager

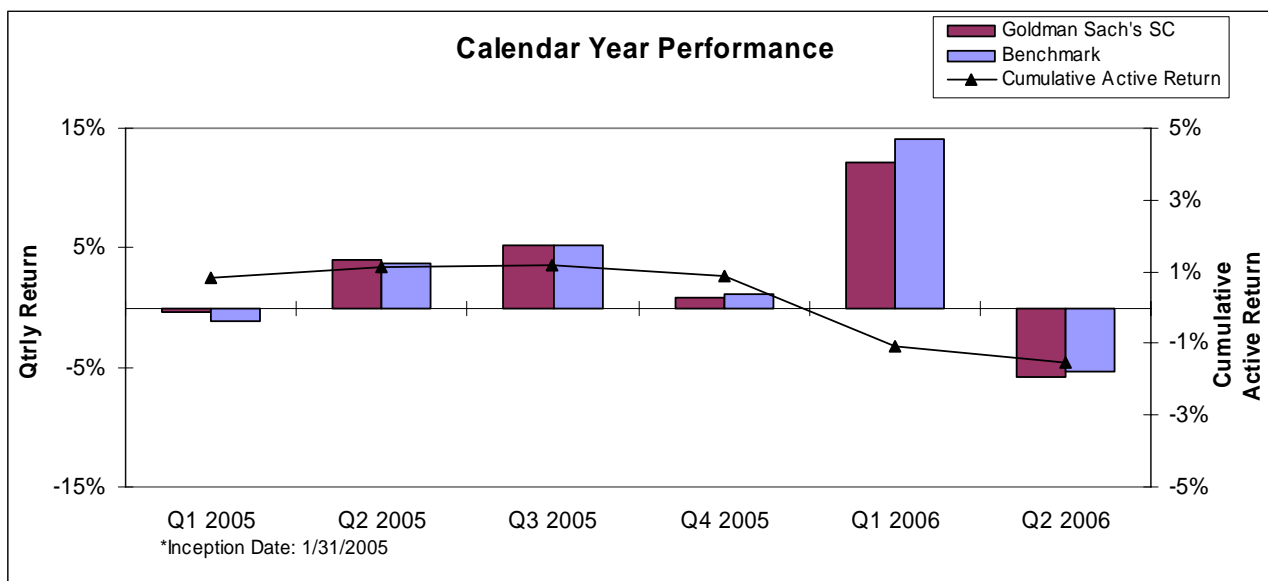
Goldman Sachs' (GSAM) small cap product was funded on February 1, 2005. The CORE ("Computer-Optimized, Research-Enhanced") indexing strategy consists of a three step process. Step 1 is to forecast expected returns on approximately 3,000 stocks daily. Return forecasts are determined using proprietary models developed by the Quantitative Equity team. Models are based on six investment themes: Valuation, Momentum, Analyst Sentiment, Profitability, Earnings Quality, and Management Impact. Step 2 evaluates the risk associated with any stock due to changing market conditions using a daily updated proprietary optimizer. In step 3, transaction costs are considered.

For the fiscal year ending June 30, 2006, GSAM underperformed their benchmark by 2.77%. Much of this underperformance can be attributed to weak factor performance in their model. Their profitability factor did poorly and negative earnings surprises on overweight stocks hurt performance. Performance from inception is 1.04% below their benchmark. Assets under management as of June 30, 2006 were \$464 million.

	Fiscal Year* 04/05	Fiscal Year 05/06	Inception* Annualized
Goldman Sachs SC	3.61%	12.07%	11.13%
Benchmark	2.46%	14.84%	12.17%
Active Return	1.15%	-2.77%	-1.04%

\*Inception Date: 1/31/2005. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows Goldman Sach's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures Goldman Sach's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## INTECH – Enhanced Indexing Manager

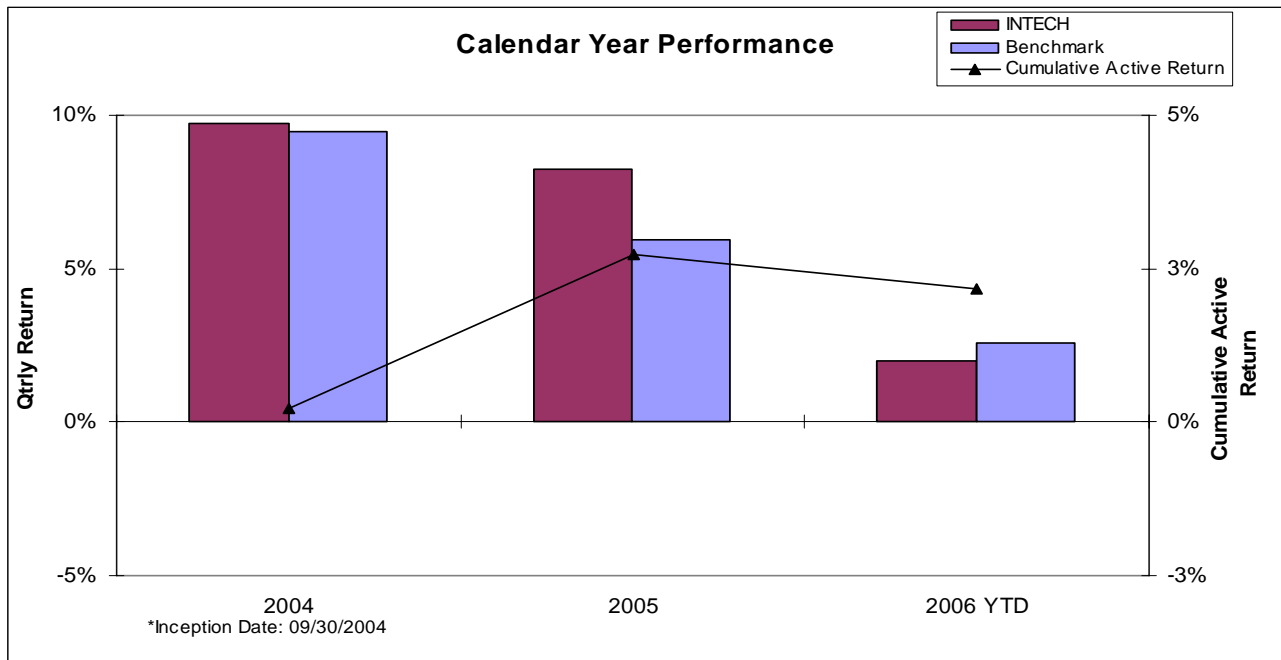
This enhanced indexing strategy, funded October 1, 2004, employs a quantitative review of the covariance and volatility of the stocks in the benchmark to identify those companies expected to outperform the benchmark. Additional bankruptcy and liquidity screens are applied to eliminate these concerns. The portfolio construction process is then applied to the remaining eligible stocks to determine security position sizes that maximize the information ratio of the portfolio and maintain a constant beta equal to or less than the benchmark. Once established, the portfolio is monitored regularly and rebalanced frequently to maintain an optimum structure.

The manager's performance was strong for the first six months of the fiscal year but deteriorated over the final six months due to weak predictability of their volatility capture model. Assets under management as of June 30, 2006 were \$1.26 billion.

	Fiscal Year* 04/05	Fiscal Year 05/06	Inception* Annualized
INTECH	12.26%	7.89%	11.57%
Benchmark	9.39%	8.74%	10.43%
Active Return	2.87%	-0.85%	1.14%

\*Inception Date: 09/30/2004. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows INTECH's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures INTECH's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Quantitative Management Associates – Enhanced Indexing Manager

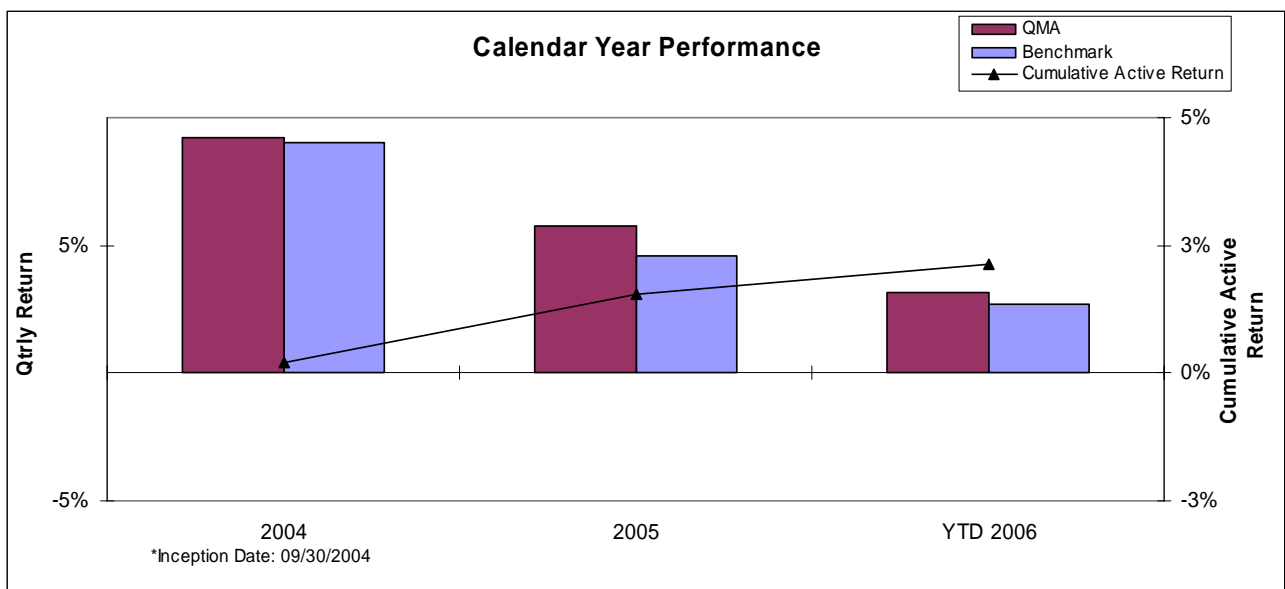
Quantitative Management Associates (QMA) Quantitative Core Equity strategy was funded on October 1, 2004. This manager uses a quantitative approach to exploit persistent, predictable mis-pricings through a three-step investment process: classify the universe of stocks by growth rate, calculate the expected alpha for each stock in the universe, and construct the optimal portfolio. The portfolio is constructed to maximize expected alpha subject to a targeted tracking error. The optimization program controls risk across multiple measures including size, value/growth, sector, industry, and individual security. Typically holdings range from 300 to 450 securities.

The portfolio slightly outperformed its benchmark by 0.13% over the trailing twelve months. Both asset allocation decisions and stock selection were positive over the period. Assets under management as of June 30, 2006 were \$931.9 million.

	Fiscal Year* 04/05	Fiscal Year 05/06	Inception* Annualized
QMA	9.77%	8.55%	10.53%
Benchmark	7.93%	8.42%	9.39%
Active Return	1.84%	0.13%	1.14%

\*Inception Date: 09/30/2004. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows QMA's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures QMA's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Smith Breeden – Enhanced Indexing Manager

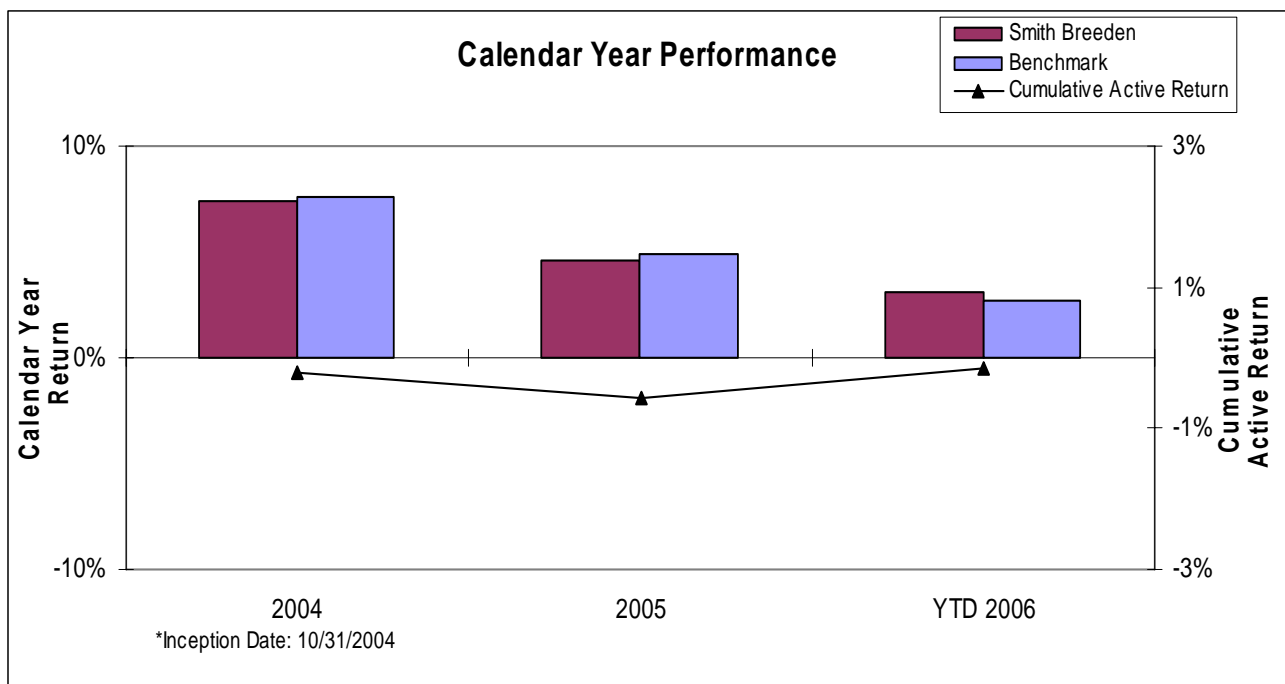
Smith Breeden's Equity Market Plus enhanced indexing investment strategy, funded November 1, 2004, combines an active short duration cash management portfolio with an S&P 500 Index overlay. The S&P overlay is normally established through an appropriate long position in S&P 500 index futures. The key to the strategy is the short duration and focus on security selection and sector rotation within the mortgage-backed, asset-backed, and corporate sectors, while minimizing duration risk relative to the benchmark.

The portfolio performed slightly above benchmark over the trailing twelve months. As with all synthetic products, performance has been hindered by rising short term interest rates and flattening of the yield curve. Assets under management as of June 30, 2006 were \$579.6 million.

	Fiscal Year* 04/05	Fiscal Year 05/06	Inception* Annualized
Smith Breeden	6.51%	8.71%	9.20%
Benchmark	6.72%	8.63%	9.27%
Active Return	-0.21%	0.08%	-0.07%

\*Inception Date: 10/31/2004. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows Smith Breeden's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures Smith Breeden's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## T. Rowe Price – Enhanced Indexing Manager

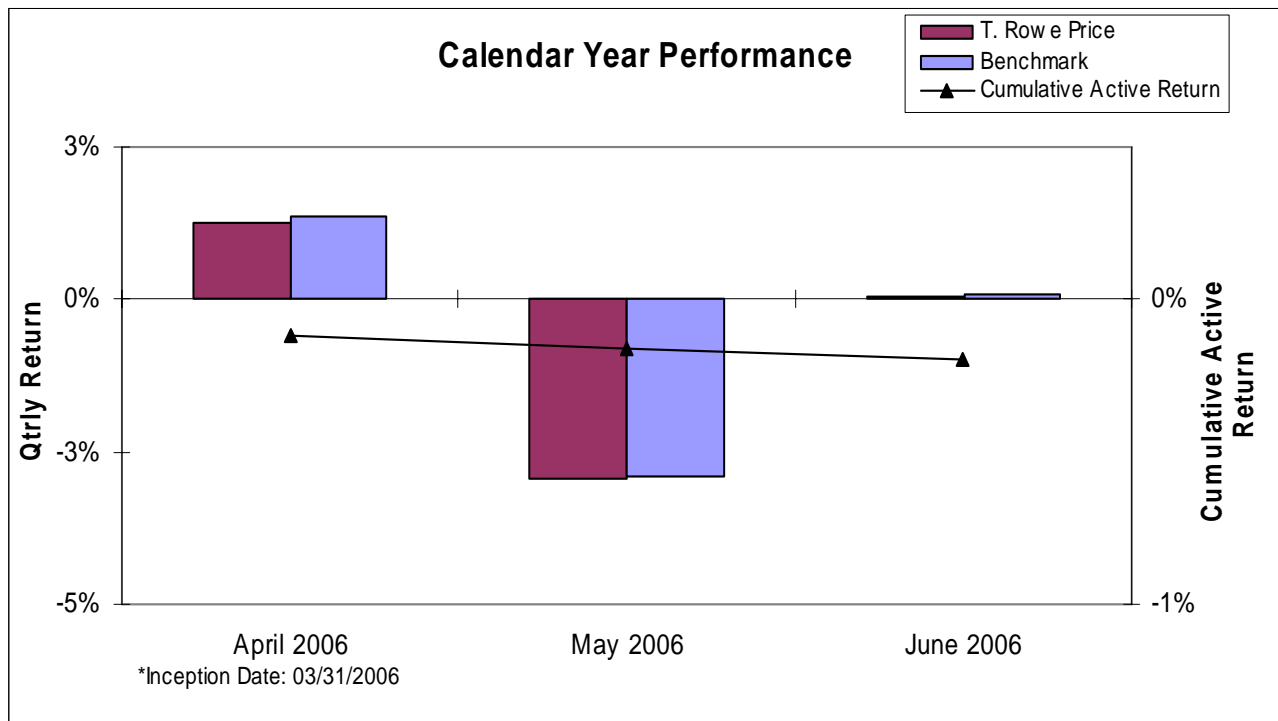
T. Rowe Price was funded on April 1, 2006. This manager seeks to outperform the S&P 500 index through stock selection, while putting tight constraints on industry and sector exposures. Stock selection decisions are made by the research analysts for each industry, with the portfolio manager constructing the portfolio in order to keep it within the targeted risk controls. The portfolio normally holds 230-310 securities.

With three months of performance completed, the portfolio is slightly trailing its benchmark by 20 basis points. Assets under management as of June 30, 2006 were \$585.4 million.

	Qtr Ending 06/06	Inception*
T. Rowe Price	-1.70%	-1.70%
Benchmark	-1.50%	-1.50%
Active Return	-0.20%	-0.20%

\*Inception Date: 03/31/06. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows T. Rowe Price's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures T. Rowe Price's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Western Asset Management Company – Enhanced Indexing Manager

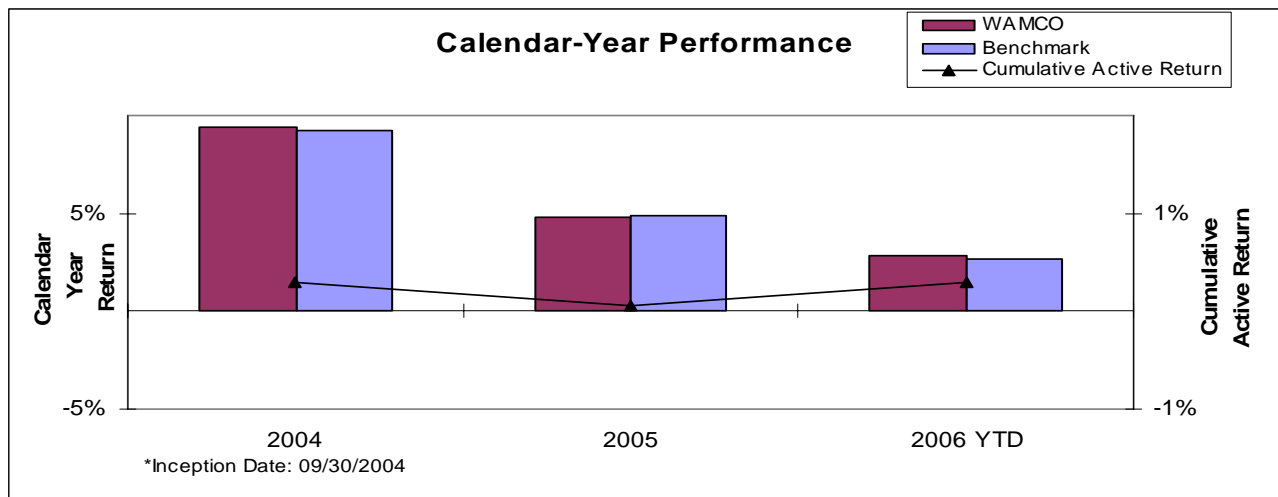
Western Asset Management Company's (WAMCO) Index Plus synthetic enhanced equity product combines S&P 500 Futures and Total Return Swaps with a cash management portfolio. This strategy, funded October 1, 2004, seeks to produce a return in excess of the S&P 500 Index while minimizing the risk of significant underperformance. The futures and swaps track the price movements of the S&P index with the excess return coming from the security and sector selection in the underlying short-duration bond portfolio.

WAMCO has outperformed the benchmark by 0.08% from inception through June 30, 2006, as shown in the below chart. Performance is in line with expectations given the continued rise of short-term interest rates and the flattening of the yield curve, making the market environment challenging for short-duration cash management portfolios. Assets under management as of June 30, 2006 were \$586.3 million.

	Fiscal Year* 04/05	Fiscal Year 05/06	Inception* Annualized
WAMCO	9.50%	8.71%	9.84%
Benchmark	9.20%	8.63%	9.76%
Active Return	0.30%	0.08%	0.08%

\*Inception Date: 09/30/2004. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows WAMCO's performance versus its benchmark. The axis on the left measures the manager's quarterly performance against its benchmark. The right axis measures WAMCO's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

## Dynamic Completion Fund – Internal Index Fund

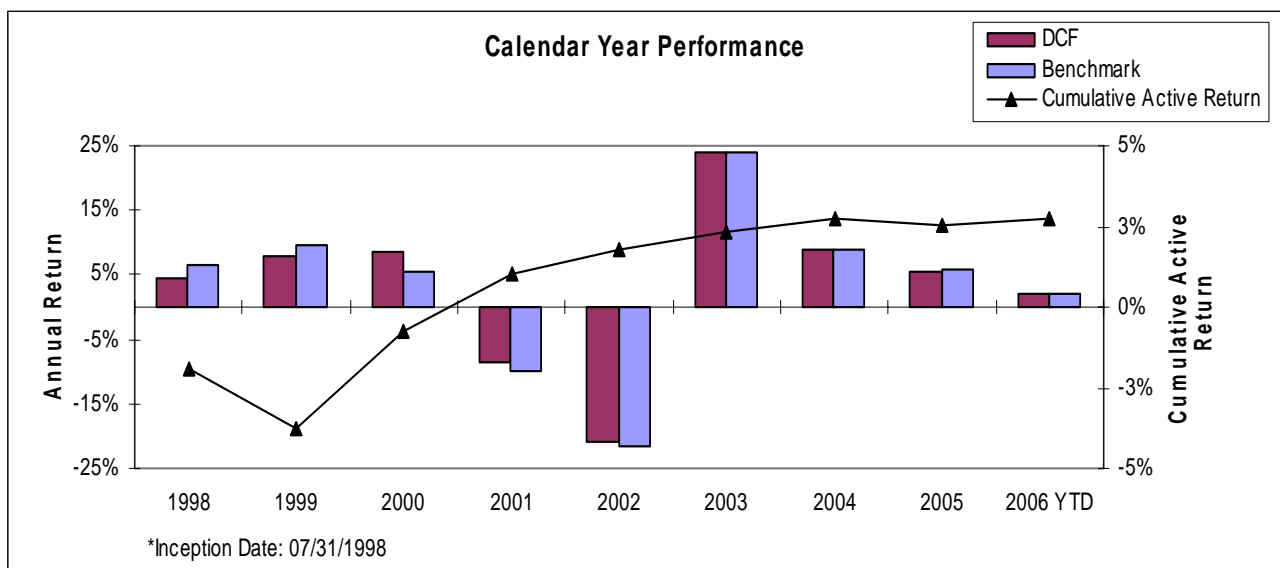
The Dynamic Completion Fund (DCF) is a specialized, passively managed, internal domestic equity portfolio that is structured to complement the active domestic equity managers' portfolios. The strategic objective of the DCF is to reduce style bias caused by the active domestic equity managers' benchmarks relative to the CalPERS Custom Wilshire 2500 Index. The DCF also provides a vehicle to facilitate manager transitions while minimizing transaction costs. The portfolio is managed and constructed using an optimized sampled approach which produces an actual portfolio with risk characteristics closely resembling the benchmark. The optimization approach employs a fundamental risk model to define and decompose the portfolio's risk exposures relative to those of the benchmark.

During the 12 months ended June 30, 2006, the DCF returned 8.16% while the benchmark returned 8.42%. Minor underperformance can be attributed to higher than normal turnover in the benchmark of 70% driven by the resignation of poorer performing managers as well as the funding of new managers. Annualized performance from inception is 0.28% above the benchmark representing \$2.8 million of outperformance per year for every \$1 billion managed. Assets under management as of June 30, 2006 were \$5.6 billion.

	Fiscal Year 01/02	Fiscal Year 02/03	Fiscal Year 03/04	Fiscal Year 04/05	Fiscal Year 05/06	Inception* Annualized
DCF	-16.76%	1.30%	16.08%	5.15%	8.16%	3.24%
Benchmark	-17.53%	0.96%	15.86%	4.97%	8.42%	2.96%
Active Return	0.77%	0.34%	0.22%	0.18%	-0.26%	0.28%

\*Inception Date: 07/31/1998. Source: State Street Bank. Returns are net of fees and CFA compliant.

The chart below shows the DCF's performance versus its benchmark. The axis on the left measures the manager's annual performance against its benchmark. The right axis measures DCF's cumulative performance relative to the benchmark.



Source: State Street Bank. Returns are net of fees and CFA compliant.

**Recommendation**

Staff recommends renewing the contracts of CalPERS' four active and nine enhanced indexing external domestic equity managers for a period of one year. Each contract contains a provision allowing for termination on 30 days notice.

**V. STRATEGIC PLAN:**

External investment manager performance is monitored by staff and reported to the Investment Committee per CalPERS Strategic Plan, Goal IV: Assure that sufficient funds are available, first, to pay benefits and, second, to minimize and stabilize employer contributions.

**VI. RESULTS/COSTS:**

The purpose of this item is to keep the Investment Committee informed of staff's efforts to ensure that the external active domestic equity manager program is performing in line with expectations.

Prepared By:

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